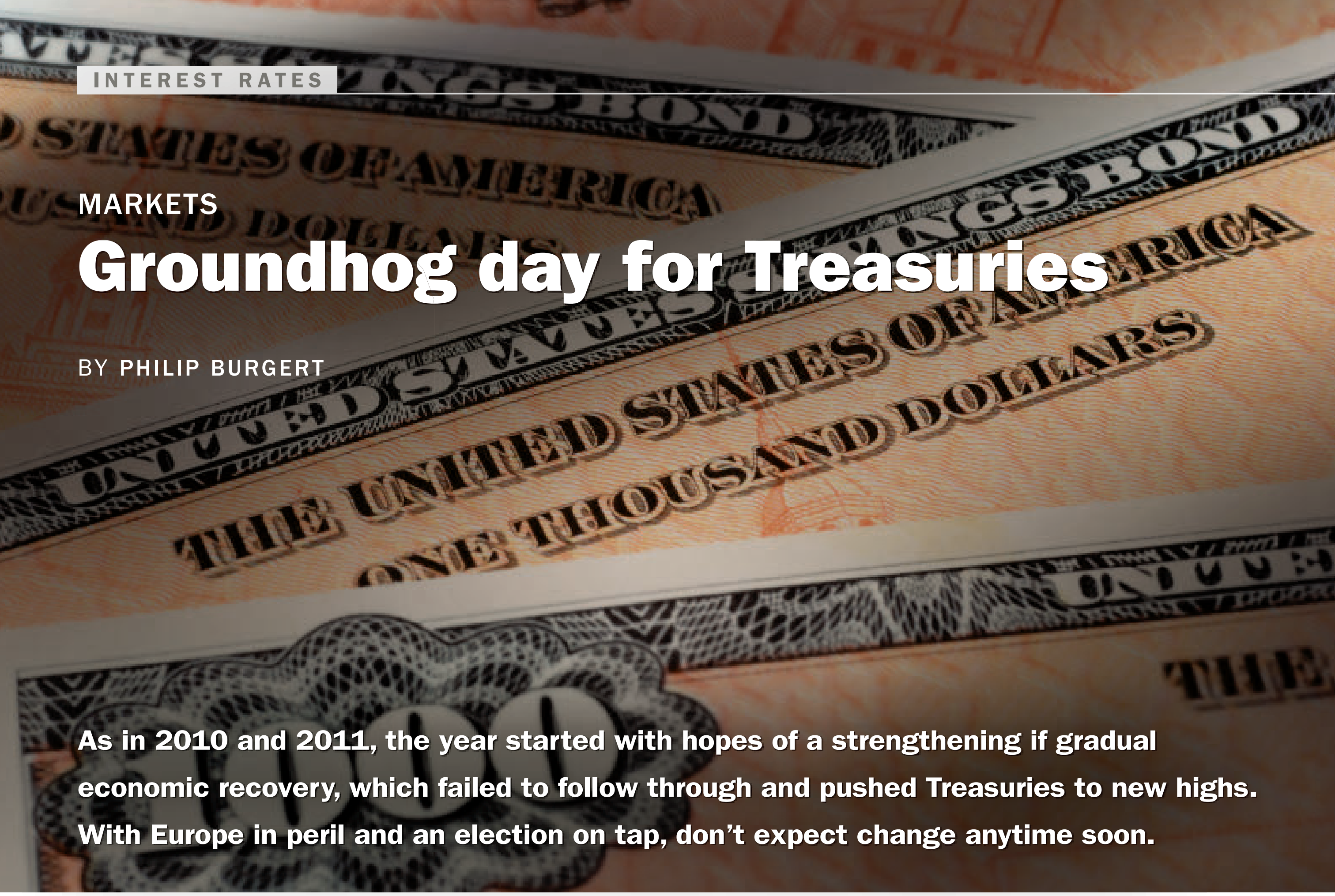

MARKETS

Groundhog day for Treasuries

BY PHILIP BURGERT

As in 2010 and 2011, the year started with hopes of a strengthening if gradual economic recovery, which failed to follow through and pushed Treasuries to new highs. With Europe in peril and an election on tap, don't expect change anytime soon.

Uncertainty over the sustainability of an economic recovery and big questions about the future of Europe and the euro are repeating for a third straight year and are driving Treasury bond yields and prices to record levels. Those central factors impacting interest rates are unlikely to change much in the next few months, analysts and bond traders say.

"The bond market is going to stay about where it is and maybe even move higher," says Justin M. Shea, president of Qualitative Capital Management Inc.

European uncertainty

A lost decade of our own

"A lot of that depends on what's going on in Europe. Europe's situation right now is probably the dominant force in the Treasury market simply because it's a flight to quality trade, which was something we witnessed last August."

Carley Garner, senior analyst and broker with DeCarley Trading, says that it is not a secret that "Treasuries are overpriced and yields are low, based on everything that seems logical. Nonetheless, the Fed has dedicated a large amount of capital toward influencing prices. It also has declared an intention to continue doing so into 2014." As such, she says it is difficult to justify expectations of a reversal in the third quarter, as many continue to expect.

Garner notes that seasonal pressures in government-issued bonds and notes tend to be supportive to bullish for much of the summer and early fall, partly because of investor allocation away from equities as they "sell in May and go away." The corrections in the last week in May and first week in June are the exceptions, she says.

"With these factors in mind, Treasuries will find comfort at prices well off the May highs, but still are relatively high based on historical standards," Garner adds. She expects the September 30-year bond future will find a home in the low 140s, range bound between 143 and 139, and the September 10-year note contract will settle in the low 130s, range bound between 131 and 129-15.

Europe's central role in the market also is cited by Jack Broz, a Chicago Board of Trade (CBOT) floor trader who also provides analysis on the bond market at TradeBondFutures.com. "They've kind of

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moved Greece behind them, but you've got Spain now. Then you have Portugal and Italy. It's just an endless list," Broz says. "Whenever those get in trouble — even though we laugh over here because of these yields they are trading at — the money flies into the bonds and notes. This keeps pushing the market higher."

Broz points out that forecasting is somewhat hazardous because of potential Fed action, but at the end of May he was looking at a trading range for 10-year September notes of 132-05 to 134-23. "Now we're trading at 134, so we could be through these in the morning. But if you're through those, you have to think that the market is taking out any possible resistance and wants to keep running," he says.

"We're at all-time low yields, so nobody has any idea up here. Nobody can look at you and say, 'Now here's resistance.' So you've got to go with the cash yield. I would say around 1.5%, then 1.25%. If we start hitting into those prices, that's about a top in the market," Broz says.

If the market rolls over, the September

10-year should find support at 132-05, Broz says. "When I talk about support, I don't talk about where I want to buy," he says. "I'm talking about if we can take this out, we should start to break. Then you break a whole point down to 131-08; if you take out 131-08, you can say that the bears are firmly in control."

For 30-year September bonds, Broz told his clients to look for a price of 150-23 but that was hit within 24 hours at 150-26 before falling off to 150-05. "We could be back above that in no time," he says. "From a technical standpoint, 150-23 is an important price. Above 150-23 — now again this is pretty close — there is 151-08, which is kind of the next level."

No top has held in the long bond and, technically, it has broken to the upside of a 30-year bullish channel (see "Long bull move in long bond," right). So, with the Fed holding the cards on rates, it is hard for bears to pull the trigger, even at these levels. "What I tell my clients is there's got to be a top somewhere. These are two places worth taking a look. Conversely, if the market takes it out, you've got to look to keep pushing. [My] ultimate target at 156 sounds absurd." That level, he notes, would raise the question of a negative yield in the five-year note. "It's possible," he says. "But that to me is where this market is trying to go."

In terms of yields, Broz says that bonds were then trading at 2.64% but could soon rally to a 2.5%, followed by a 2.25% yield; that would be the top. "We're going to keep fishing; eventually people [will] say, 'We can't push it like this,' Broz says.

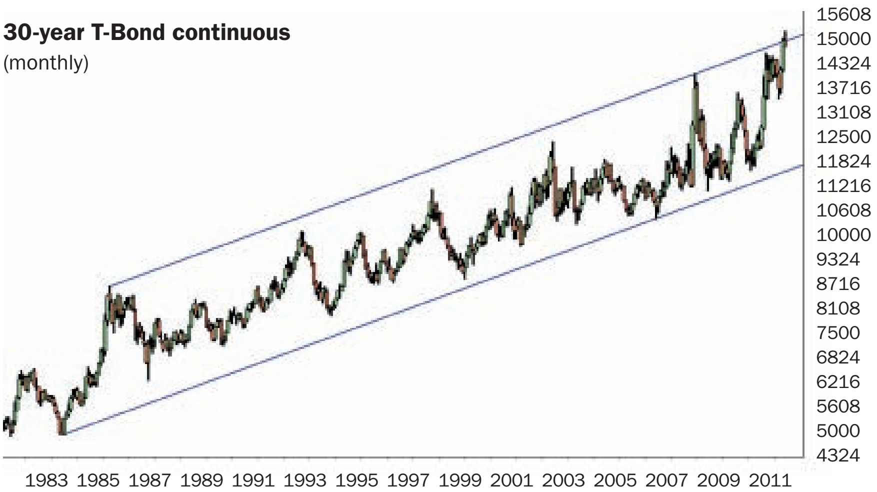
If the 30-year market starts to break down, Broz sees an area of support at 147-28 to 146-06. "Now that's a huge area, but that's [one] that people could look at as some support. Then if you take that out it looks a move down to 143," he says, adding that longtime traders believe a breakdown is likely, leading to a once-in-a-lifetime move.

"It's going to be a career move," Broz says. "People think when this thing breaks it's going to break fast and hard. But there's support the market has built in."

Over the past nine months, the U.S. economy has shown signs of improvement, but Treasury rates have remained range bound with the yield on the 10-year

LONG BULL MOVE IN LONG BOND

In June, 30-year Treasury bond futures broke out of a 30-year bull channel. Perhaps it is a blow off top, but with the Fed holding the strings, bears beware.



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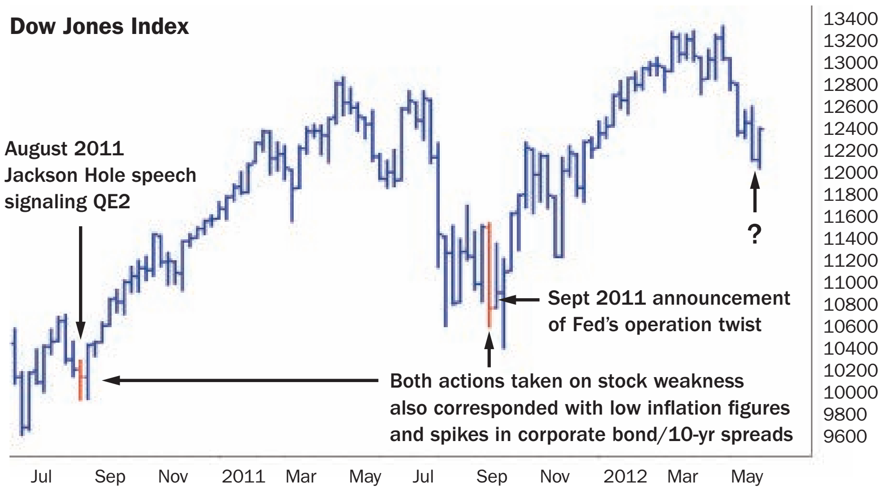
TREASURY STIMULUS ARGUMENTS

The Fed has provided a policy back-up every time stocks appeared to be faltering. Are they teeing up more after this May's performance?



Source: eSignal

note trading between 1.70% and 2.40%, until the recent surge caused by disappointing economic numbers, notes Sean Lusk, stock index analyst with PFGBest.

"One reason that rates have not moved higher could be that the markets are not convinced of the sustainability of economic growth," he says. Another reason may be the growing concern over the crisis in the European Union and the spill-over effects that may have in the U.S., he adds.

Not surprisingly, given the safe haven status of Treasuries, rates across the curve had moved sharply lower with the yield on the 10-year Treasury note. While the 10-year has bounced from record low levels, "Nothing precludes it from moving lower in the near-term, especially if the situation in Europe worsens," Lusk says.

"The argument going forward will be the trend remains your friend for both the 10- and 30-year, with the 10-year hitting below 1.50% if more stress arrives from the European debt crisis. If we do see greater contagion risk from Greece and Spain, the [European Central Bank] and ultimately the Fed will come in with supportive policy stances to combat the crisis," he says.

Garner says that Treasury bulls also have grown overly comfortable knowing the Fed essentially is offering a put option on bond prices. Likewise, the bears have not fared well and have become hesitant to place bets against the Fed by shorting bonds and notes. This has been displayed by the market's tendency to rally on chatter or expectations of more quantitative easing measures, but to soften as the actual programs are implemented.

Derek Holt, an analyst with Scotiabank, says that lower Treasury yields are not the motivation of the Fed in any consideration of additional asset purchases and that market inflation expectations, stocks and corporate bond spreads provide justification for further quantitative easing (see "Treasury stimulus arguments," page 17). "The Fed judged higher Treasury yields following QE efforts as a policy success," he notes.

"If these trends push even further, as we think they will, the Fed could argue that additional stimulus should be designed to ward off fatter tail downside risks to inflation, either in the form of a too-sharp pace of disinflation or a return to outright deflation risk itself," Holt says.

Investor psychology going forward will be precarious at best as apprehension and fear have ramped up during recent weeks, Lusk says. The yield curve has flattened, while the dynamics at the front-end do not appear set to change in the near-term, and the intermediate portion of the curve experiences increases expectations of further Fed easing.

Lusk notes that expectations grew after the release of April's Fed minutes that stated a shift from a "couple" of Fed members to "several" members of the Fed "indicated that additional monetary policy accommodation could be necessary if the economic recovery lost momentum or the downside risks to the forecast became great enough."

Federal Reserve Board Chairman Ben Bernanke did not signal QE3 in addessing Congress on June 7, a few days after a second consecutive disappointing employment report as many analysts had anticipated, but he didn't rule it out either. While the Fed extended its commitment to a zero interest rate policy through 2014 in early January, the market for Fed funds has been volatile and appears to be following the jobs numbers (see "It's jobs, stupid!" above).

But continuing declines in yields also raise comparisons to Japan's experience of declining rates in the 1990s (see "Long, low rates in Japan," above) and the extended recovery of interest rates from the Great Depression. "You can look at the problem from a lot of different angles," Shea says, who notes that Japan's experience is viewed as a lost decade.

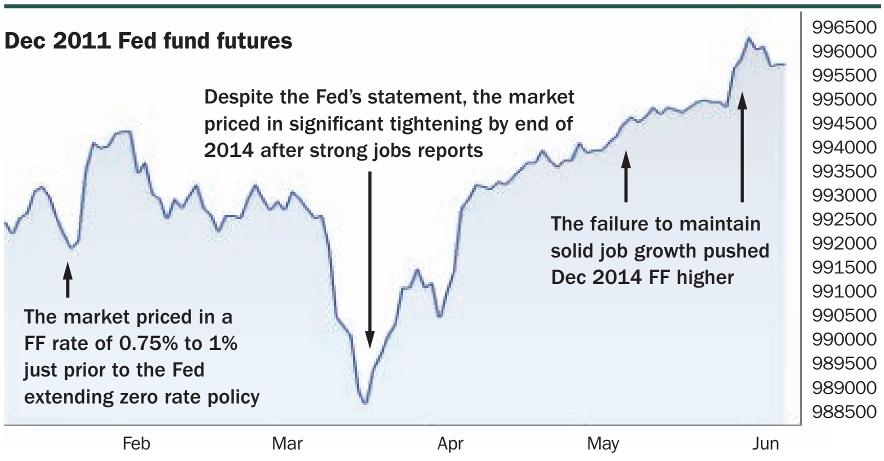
But he adds that Japanese unemployment never really declined during that decade while U.S. unemployment has. "It is relevant and you have to look at it, but it's not just about zero rates," Shea says. "You also have to consider the way in which that was administered and also what the fiscal policy was at the time. If we're pursuing different fiscal policies, there might be different outcomes."

No one wants to replicate Japan's lost decade, which is now going on decades.

What is clear is that Treasuries cannot stay at these inflated levels forever; the questions are: When will rates begin to rise and how orderly of a move will it be? F

IT'S JOBS, STUPID!

Even though the Fed, in January, had extended its zero rate commitment to the end of 2014, Fed funds futures have been reacting to the employment data.



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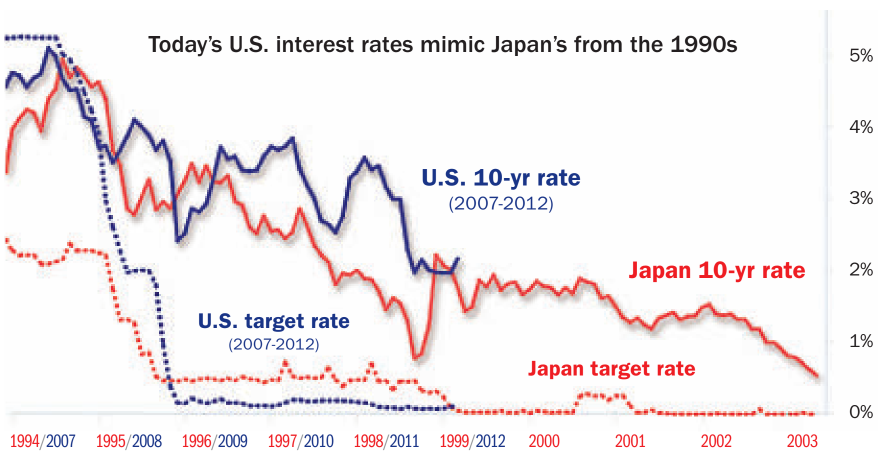
LONG, LOW RATES IN JAPAN

Japan experienced a lost decade in the 1990s as interest rates continued to fall.



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